

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF ENVIRO UTILITIES,)	
INC., FOR AN ADJUSTMENT OF RATES)	
PURSUANT TO THE ALTERNATIVE RATE)	CASE NO. 9101
FILING PROCEDURE FOR SMALL UTILITIES)	

O R D E R

On July 13, 1984, Enviro Utilities, Inc., ("Enviro") filed an application with the Commission to increase its sewer rate pursuant to 807 KAR 5:076, Alternative Rate Adjustment Procedure for Small Utilities ("ARF"). Enviro's proposed rates would produce additional revenue of approximately \$20,635 annually, an increase of 38.4 percent over test-period actual operating revenues of \$53,685. In its Order of January 31, 1985, the Commission granted Enviro an increase in revenue of \$1,640 annually, an increase of 2.6 percent over normalized revenues of \$63,555.

Prior to issuance of that Order, the Commission issued two information requests in which it required Enviro to submit information on various items, including the three issues eventually raised by Enviro in its petition for rehearing which was filed February 21, 1985. The three issues involved the treatment of: 1) routine maintenance fees; 2) interest on long-term debt; and 3) interest on short-term debt. In its Order of March 13, 1985, the Commission allowed rehearing on the three issues raised by

Enviro, primarily because there had been no hearing prior to issuance of the Commission's Order of January 31, 1985, since the case was filed under the ARF procedure. Also, Enviro was required to submit prefiled testimony.

Enviro submitted prefiled testimony on April 17, 1985, and a hearing in the case was held at the offices of the Commission on June 5, 1985. Since several utilities owned by Carroll Cogan and serviced by Andriot-Davidson's Service Company, Inc., ("Andriot-Davidson Service") had cases pending in which routine maintenance fees were an issue, it was agreed that routine maintenance fees would be considered as a generic issue in this case and the testimony would be incorporated into the other cases being reheard on this issue.

Another hearing was held October 16, 1985, in this case to afford Enviro's customers an opportunity to comment, since the Commission had received numerous protest letters and requests for a public hearing. The Commission had ordered Enviro to be prepared to respond to any questions concerning information previously furnished which had been requested at the hearing of June 5, 1985.

Routine Maintenance Fee

The issue of the routine maintenance fee has been a matter of much contention in cases involving sewer utilities owned by Carroll Cogan, inasmuch as this transaction has been defined as a less-than-arms-length transaction. The issue of affiliated company transactions goes well beyond the monthly payment for routine maintenance. Mr. Cogan has acquired ownership and operating

control over approximately 31 small sewer utilities which generally cannot afford to hire full-time employees, purchase their own transportation equipment, maintain an office, and achieve operating efficiencies available to larger utilities. The operations, materials and supplies, and other services are provided these small utilities through a business organization also owned by Mr. Cogan. During numerous rate case proceedings over the past several years, these operations have been investigated in varying degrees and judgments have been made by the Commission as to what costs are reasonable. In general, the investigations on the reasonableness of expenses have been limited to specific expenses of one of the regulated sewer utilities, and the Commission has not attempted in the past to delve into the operations of Mr. Cogan's service companies, since these businesses are not under the jurisdiction of the Commission. Concern has been expressed by the Commission in many Orders about the conflict of interests existing with the owner of the sewer utility incurring a majority of its expenses with businesses of mutual ownership. The Commission maintains its position that these transactions must be closely scrutinized and that the burden of proof is on the utility to show, through documented evidence, that these transactions are reasonable.

In the Order of January 31, 1985, in this case, the Commission reduced the routine maintenance fee which Enviro pays to Andriot-Davidson Service on the grounds that Enviro had not offered sufficient evidence that the increase in the fee, over what was allowed in Enviro's last rate case, was reasonable.

Enviro, and five other Carroll Cogan-owned utilities petitioned for rehearing on this issue. In the Order of March 13, 1985, granting rehearing in this matter, the Commission advised Enviro that, to meet its burden of proof on this issue, it must provide documented evidence that the transactions with Andriot-Davidson Service are reasonable in comparison to transactions of Andriot-Davidson Service with non-affiliated companies, that the prices paid by Enviro for materials and services acquired from affiliated companies are at market or less, and that, although these materials and services are acquired from affiliated companies, they are obtained at the lowest possible cost. The Commission advised Enviro that it would not accept the type of evidence offered on this issue in the past and enumerated nine areas that Enviro should address to show that these transactions are reasonable.

Enviro offered witnesses: Larry W. Smither, Vice President, General Manager, Andriot-Davidson Service; Martin G. Cogan, Vice President, Andriot-Davidson Company ("Andriot-Davidson") in Charge of Sales; Stephen R. Bell, Andriot-Davidson Service, Shop Foreman and Supervisor; and Charles B. "Pat" Logsdon, CPA. The testimony of these witnesses addressed the nine areas outlined in the Order granting rehearing. Mr. Smither testified solely on behalf of Andriot-Davidson Service. The prefiled testimony of Mr. Smither addressed the comparability of the routine maintenance contracts between affiliated and non-affiliated sewer utilities, the comparability of services provided to affiliated and non-affiliated sewer plants, comparability of prices, comparability of

cost of materials, the comparability of returns of Andriot-Davidson Service to other sewage plant service companies, and the question of subsidization between utilities serviced by Andriot-Davidson Service. Martin Cogan testified solely on behalf of Andriot-Davidson. His testimony addressed the methods used within Andriot-Davidson to acquire materials and services for the affiliated utilities and how the prices were determined. Mr. Bell testified on the acquisition of materials and services for affiliated and non-affiliated sewer facilities. Mr. Logsdon's prefiled testimony addressed the hourly rate charged by Andriot-Davidson Service for labor, the level of service subsidization, and the poor financial condition of the affiliated sewer utilities.

The evidence presented by Enviro in this case encompasses not only the operations of Enviro and other sewer utilities but also the operations of two private enterprises not regulated by this Commission. The Commission must make a decision at this time on the issue of whether the evidence in this case supports the ongoing contentions of Carroll Cogan that affiliated company transactions are reasonable. In order to address the issues in this matter from the primary concerns of the applicant in this case, Carroll Cogan, we will address the issues contained in Enviro's brief submitted on September 30, 1985.

Enviro states in its brief that evidence has been submitted that all transactions between Enviro and other associated utility companies are at arms-length and that hourly labor rates were equal to and most times less than Andriot-Davidson Service's normally quoted labor rates. Carroll Cogan states further that

Andriot-Davidson Service's accountant presented data demonstrating that Andriot-Davidson Service should be charging all customers higher hourly rates to improve its profit picture. Mr. Logsdon stated in his prefiled testimony that he has recommended to Andriot-Davidson Service that it should charge \$35 per hour for services under various treatment plant operating contracts. Mr. Logsdon's testimony contained no information that would explain how the \$35 rate was determined. In response to cross-examination, Mr. Logsdon stated that he did not have the authority to discuss the costs used as a basis to determine the \$35 rate, since they are computed for Andriot-Davidson Service (a non-regulated entity). Upon additional questioning as to support for the hourly rate and other consultation with his client, Enviro's Attorney, Wallace H. Spalding, III, stated that the current tax returns and a breakdown of the accountant's analysis arriving at the \$35 per hour charge would be supplied. At that point, Chairman Heman noted that the Commission staff would be deferring any questioning on this issue until after documentation of the cost analysis was provided.¹ Subsequent to the June 5, 1985, hearing, the tax return and a calculation of the \$35 rate was supplied. A further hearing was conducted on October 16, 1985, and Enviro was advised, in the Order scheduling the hearing, that it should be represented by appropriate officials to respond to questions concerning information provided in response to questions at the June 5, 1985, hearing. At the hearing of October 16, 1985,

¹ Transcript of Evidence, June 5, 1985, page 198.

Mr. Spalding stated that he was aware that witnesses had been requested but stated further that the information would have to stand on its own and requested that the case be submitted. Mr. Spalding stated that he understood that the information may not be accepted, since the witness providing the information was not made available for cross-examination.

The information provided in the form of a tax return and a simple calculation of a \$35.63 per hour rate based on undocumented labor hours and cost data from the tax return is not sufficient proof that the hourly rate of \$25 is reasonable. The Commission informed Enviro, when the rehearing in this case was scheduled, that it would not consider undocumented statements in support of the affiliated company transactions. Therefore, the evidence, with regard to the hourly charge, cannot be used as a basis for contention that the affiliated company transactions are reasonable.

Enviro contends in its brief that testimony was provided to confirm that, on equipment and parts sold to Enviro and associated companies by Andriot-Davidson, prices are less than normal retail due to Andriot-Davidson's position as an exclusive manufacturing agent or representative.

A considerable amount of the testimony at the hearing on January 5, 1985, related to the pricing of materials and services by Andriot-Davidson and Andriot-Davidson Service. Martin Cogan contended that the prices charged Enviro by the affiliated Cogan companies are reasonable, since the hourly rates for service are less than those charged three other customers (City of Versailles,

City of Wilmore and Ramada Inn East of Louisville, Kentucky); since prices paid for materials and equipment are at less than suggested retail; and since, in some instances, the affiliated companies are not charged any markup on major equipment purchases. The only documentable evidence provided in support of any of these contentions was selected bills rendered to these three entities. No evidence was provided to show specific instances where comparable transactions were made with affiliated and non-affiliated entities. Moreover, no documentation of any sort was provided reflecting that Andriot-Davidson supplied materials to affiliated companies with no markup. Again, the Commission stated that Enviro's position would have to be supported with documented evidence and the witnesses provided none.

Enviro stated in its brief that substantial testimony was provided to support that materials, parts and services were secured through shopping, and competitive prices were secured when possible. As to the evidence in this case, the Commission concurs that testimony to this effect was given by the witnesses in this case; however, when asked if documentation had been supplied to support this contention, the witnesses produced none.

In addition to the points raised by Enviro in its brief, the Commission had requested evidence showing that there was no subsidization between the Carroll Cogan-owned companies, that comparable contracts existed among the affiliated and non-affiliated entities receiving service from Andriot-Davidson Service, and that comparable service was being received for comparable routine maintenance fees. Questions were asked at the

hearing of Mr. Smither regarding the amount of time spent in providing routine maintenance to the treatment plants. Mr. Smither stated that time studies were done periodically on each plant as a basis of regulating the fees charged. He further indicated that these studies would support the number of hours that are billed under the routine maintenance contract. However, when asked if he intended to file any of these studies, Mr. Smither stated that he would take it under advisement. No studies were filed. When asked what the basis was for his statement that there is no subsidization between the affiliated companies, Mr. Smither responded that there was none. He further testified that he did not know the cost of serving Enviro as opposed to the routine maintenance fee charged Enviro, and stated that no documentation has been provided in this case to show that the Cogan companies received preferential treatment.

The Commission is perplexed as to a means to resolve this continuing issue. In this case, the Commission set out specific criteria that must be met to justify the routine maintenance fee. The Commission pointed out that Enviro should provide documented evidence on the reasonableness of these related company transactions. The rehearing in this case encompassed months of evidentiary proceedings, including a full day of hearings on the routine maintenance issue alone. The Commission found these proceedings to be very informative and felt that Carroll Cogan had made a sincere effort to resolve this issue by providing witnesses of non-regulated companies to testify on the related company transactions. However, repeated requests for documentation of the

various contentions made by these witnesses resulted in very little, if any, evidence to support the basic contentions. The Commission is disappointed in the fact that this much time and effort have been expended to no avail. The Order of the Commission setting this case for rehearing indicates clearly what is required to support the routine maintenance charges and other related party transactions and, until Enviro can meet its burden of proof in this area, no further increase in routine maintenance fees can be allowed.

In considering the affiliated company transactions under the nine parameters established in the Commission's Order granting rehearing in this case, the question surfaces immediately as to the extent, if any, to which the Commission can examine the operations of non-regulated businesses. Mr. Logsdon brought this issue to light in his responses to cross-examination. It was Mr. Logsdon's contention that he could not disclose financial information of his clients which involved the non-regulated segments of their businesses. Mr. Logsdon further contended that the Commission should be looking to Enviro and its financial condition rather than being concerned with the return earned by Andriot-Davidson and Andriot-Davidson Service.

The Commission disagrees with these contentions. It was noted at the hearing of June 5 that the situation was similar to the affiliated company transaction of the Bell Companies and Bell labs, the General Telephone Service Companies and General Telephone Supply Companies, and other situations where goods and services were obtained from affiliated companies. The Commission

is of the opinion that, in fact, these operations are so heavily commingled in accounting, management and ownership that the whole operation must be examined to obtain a true picture of the individual pieces. At his own initiative in this case, Carroll Cogan introduced testimony which, for the first time, extensively explained the corporate structure and allowed insight into the entire operations. It is evident, from this testimony, that the operations are so complex that the management of Andriot-Davidson Service cannot determine with adequate documentation whether its fees for goods and services are compensatory or excessive. Prices for goods and services are set with more consideration to what the market will bear than the cost of doing business.

As a result of these hearings, the Commission is even more strongly convinced that the operation of sewer utilities by Carroll Cogan has become so complex and intricately involved that the present system of accounting to this Commission is inadequate and should be modified to provide better documentation of joint costs and a better measure of assurance that the affiliated company transactions result in the reasonable operating costs for these utilities. The Commission would like to see Mr. Cogan reorganize his sewer operations in a way that would provide better accountability for the costs incurred by the individual utilities. This could be accomplished by setting up a sewer operating and management company with its own employees separate from the other affiliated companies. This company would provide service to the sewer utilities and costs would be accounted for as direct charges

or as allocated expenses among all of the sewer utilities. Transportation vehicles, work force, office space and management expertise would be handled through this newly created company and expenses would be allocated. The only alternative to this type of arrangement would be complete access to the books of the total operations of Carroll Cogan and allocation of expenses between the regulated sewer operations and the other commonly-owned businesses. The Commission will allow Mr. Cogan 120 days to respond to the Commission's suggestion and to devise a plan to satisfy the needs of the Commission and, at that time, another proceeding may be undertaken to consider the proposals made.

Interest on Long-Term Debt

In its petition for rehearing, Enviro requested the Commission to reconsider this issue and to limit the averaging of the interest expense to a maximum of 3 years. The Commission allowed rehearing to afford Enviro the opportunity to present any evidence deemed appropriate as to why this issue should be treated in a different manner than it had been in Enviro's last rate case. Enviro filed a brief with the Commission on September 30, 1985, but presented no further evidence to persuade the Commission to depart from its determination on this issue in its Order of January 31, 1985. The record in this case does not support Enviro's contention that the annual interest expense on long-term debt should be increased.

Interest on Short-Term Debt

In its Order of January 31, 1985, the Commission disallowed, for rate-making purposes, interest expense on short-term

debt to associated companies and service charges on late payments to various suppliers, including Andriot-Davidson. Enviro stated that proceeds of the loans from associated companies were used to pay current obligations, and the Commission found that to allow either the interest expense or service charges would constitute retroactive rate-making. In the brief filed by Enviro on September 30, 1985, the issue of interest on short-term debt was not even addressed. Since Enviro has presented no new information on this issue, The Commission cannot accept Enviro's contention that interest expense on short-term debt should be allowed for rate-making purposes.

SUMMARY

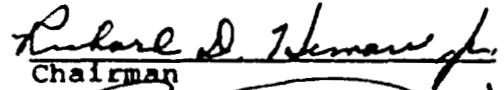
The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that Enviro has failed to present sufficient evidence to support its argument that interest on current payables and losses should be allowed, that the annual interest expense on long-term debt should be increased, and that the monthly routine maintenance fee should be increased.

IT IS THEREFORE ORDERED that:

1. The Findings and Orders of the Commission's Order of January 31, 1985, be and they hereby are affirmed in all respects.
2. Carroll Cogan shall file a response to the Commission's suggestion that the service company operations be changed to provide better accounting for the costs of the sewer utilities, within 120 days from the date of this Order.

Done at Frankfort, Kentucky, this 12th day of August, 1986.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director